FRC GUIDELINES ON ENFORCEMENT MEASURES AGAINST RECOGNISED SUPERVISORY BODIES AND RECOGNISED QUALIFYING BODIES

ICAEW welcomes the opportunity to comment on the consultation document *Guidelines On Enforcement Measures Against Recognised Supervisory Bodies And Recognised Qualifying Bodies* published by the Financial Reporting Council (FRC) on 28 November 2014, a copy of which is available from this link.

This response of 20 February 2015 has been prepared on behalf of ICAEW by ICAEW Professional Standards, the regulatory arm of ICAEW. Over the past 25 years, ICAEW has undertaken responsibilities as a regulator under statute in the areas of audit, insolvency, investment business and most recently Legal Services. In discharging our regulatory duties we are subject to oversight by the FRC's Conduct Committee, the Irish Auditing and Accounting Supervisory Authority (IAASA), the Insolvency Service, the FCA and the Legal Services Board.

ICAEW is the largest Recognised Supervisory Body (RSB) and Recognised Qualifying Body (RQB) for statutory audit in the UK, registering approximately 3,500 firms and 9,300 responsible individuals under the Companies Acts 1989 and 2006.

ICAEW is the largest Prescribed Accountancy Body (PAB) and Recognised Accountancy Body (RAB) for statutory audit in Ireland, registering approximately 3,500 firms and 7,500 responsible individuals under the Companies Act 1990.

This ICAEW response also reflects consultation with the ICAEW Business Law Committee and the ICAEW Audit and Assurance Faculty.

The ICAEW Business Law Committee , which includes representatives from public practice and the business community. The Committee is responsible for ICAEW policy on business law issues and related submissions to legislators, regulators and other external bodies

The Audit and Assurance Faculty is recognised internationally as a leading authority and source of expertise on audit and assurance issues. The Faculty is responsible for audit and assurance submissions on behalf of ICAEW. The Faculty has around 7,500 members drawn from practising firms and organisations of all sizes in the private and public sectors.

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ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

MAJOR POINTS

1. We note the publication of the consultation paper which articulates the proposed approach of the FRC under powers given to it under article 4 of Statutory Instrument 1741 The Statutory Auditors (Amendment of Companies Act 2006 and Delegation of Functions etc) Order 2012. The article amends section 1225 of the Companies Act 2006 (the act) dealing with enforcement.

2. The powers were put in place following the consultation paper *Proposals to Reform the Financial Reporting Council published in October* 2011which we commented upon in our representation of December 2011. In particular we expressed misgivings around the appropriateness of placing these sanctioning powers with an oversight body, and questioned the public perception basis for the proposals rather than evidence of existing processes not working. Indeed current evidence points to a high degree of compliance and willingness by the RSB's to self-report where things do not go right. The self-reporting by ICAEW and ACCA around issues associated with the qualification in the last two years are indicative of that high level of cooperation and commitment to quality. This goodwill and public interest pursuit risks being compromised by a sanctions regime.

3. Whilst the powers have nevertheless been enacted, the challenges in articulating the process behind their exercise are brought to the fore in this new consultation paper

4. The appropriateness of the sanctions framework is called into doubt by the questionable effectiveness of outcomes. Any sanction destabilises the recognised body financially and in the quality of regulatory supervision it exercises. But more importantly it calls into question the integrity of that body. Integrity is not a commodity that comes in degrees. A body or an individual either has it or it hasn't. And if a regulatory body performs any of the actions that are suggested might give rise to varying types and degree of sanction, then the integrity of that body is compromised. If a body lacks integrity then it should not be in the business of regulatory supervision. The "nuclear option" which has always been in the framework of the legislation under the opening sections of schedule 10 to the Act is for this very purpose. The laudable use of the Hampton principle of proportionality in a sanctioning policy may fit well with the regulation of newspapers and utilities, but where public trust and market and consumer confidence are at stake they are simply not appropriate.

5. However we recognise that a sanctioning regime for regulatory bodies is part and parcel of current business conduct in the UK, and that it is important that BiS and the FRC keep pace with these developments. The FRC needs to be seen to be able to be fulfilling its oversight role with the normal regulatory tools at its disposal. However these have to be seen by both the regulated bodies and the general public as fair and proportionate in their application, and that the outcomes sought through the regime are clearly defined and in the public interest. We do not believe that these outcomes have been fully addressed, and that the processes as proposed in this document are not fair and risk challenge in the courts to the detriment of the profession, confidence of the public in the regulatory process, and the reputation of the FRC itself.

6. It may simply be a weakness in the positioning of the document, but these provisions should be simply a last resort when all else fails, rather than a routine application. Every effort should be made by the oversight body and the relevant recognised bodies to arrive at a compromise and direction of travel that enhances audit quality and achieves the public interest, before resorting to enforcement of this nature. Perhaps that is still intended but it is not conveyed by the document. A second implication in the document's positioning is the almost inherent assumption that the transgressions that would trigger the sanctions happen as a matter of course. This belies a history where there has been few if any circumstances that such sanctions had they been in place would ever have been exercised. Both the RSBs and RQBs through their ethical and professional standing are as engaged in the pursuit of audit quality as the FRC. The issue of the document without such recognition immediately downplays the quality of monitoring and oversight that has been effected to date on the FRC's watch.

7. There is also a concern that the approach seeks to emphasise too much the independence of the FRC from the regulatory bodies. In practice the regulatory oversight framework used for the audit profession is intended through the 2004 and 2006 Companies Acts to be a joint endeavour by the FRC and regulatory bodies to ensure the quality, professionalism and independence of the delivery of audit by the profession. By levying sanctions on those bodies the FRC would appear to be acting as a protagonist against one of its own allies. That is an illogical part of the framework being applied here.

8. At a detailed level we see concerns around the behaviours these policies might drive, the governance issues which lay the system open to challenge in the European Court of Human Rights, and the downward pressures on audit quality caused by sanctioning which should be at the heart of these proposals rather than a side issue. In particular we see a significant risk that sanctions can act as powerful deterrents to exercising the very behaviour that the FRC is clear it wants to give credit for, namely owning up to errors. Such penalties create an incentive to conceal or play-down errors. Even if this does not happen at the macro organisational level, a manager in the chain may think twice about passing on information they have if they fear the downstream effect.

9. Both as a Recognised Supervisory Body and a Recognised Qualifying Body ICAEW currently has a strong and constructive relationship with the FRC that is conducive to the pursuit the regulatory objectives of audit quality, independence and transparency. We do not believe arbitrary deployment of these sanctions would sustain that quality of relationship and would weaken the achievements being made on those objectives. Before inflicting penalties, it should be essential for FRC to consider if this is the best way to encourage openness, self-declaration of errors and a willingness to accept, fix quickly and move on rather than a tendency to challenge and delay. The point is to build and sustain a relationship of trust, fairness and proportionality As a consequence we see the policies and procedures in this paper as academic discussions rather than a statement of practice, as either an argued compromise or a revocation of recognition will in practice be the effective outcomes where there are areas of dispute.

RESPONSES TO SPECIFIC QUESTIONS

Q1: Do you consider that the proposed Guidelines provide a clear framework to guide the decision making of the Board when imposing Enforcement Measures?

10. We believe that the guidance seems to be narrowly focused at a tactical level rather than a strategic one. This flows from the stated aims and objectives which appear to be focused on getting the recognised body to fall into line immediately with the FRC's requirements, rather than standing back and stating that the aims are focused around the necessary environment for the effective conduct and supervision of audit and the deployment of the appropriate skills base. This then brings the aims and objectives into conflict with later assessments that refer to proportionality and potential harm to public which are outside the stated aims.

11. In our view the aims and objectives should be more widely drawn and the enforcement regime set in context within that rather than being a set of aims within themselves. In that way a wider view can be taken as to why there is a need to pursue the enforcement and the advantages/disadvantages of exercising these options can be more broadly considered. The wider objectives would embrace those of the FRC and the charters of the recognised bodies.

12. Compelling a recognised body to do something should in any case be seen as a last resort. A process of engagement should be pursued as far as possible before this stalemate position is reached. The framework however does not address whether these steps have been fully pursued before the process of enforcement is initiated. We believe a key part of the process should be a commitment to action plans (to remedy issues), conditions, restrictions and publicity - but clearly with the expectation that they'll be used as threats - with sensible timelines being given to fix issues before external actions and sanctions are imposed

13. The framework as set out lacks clarity over how genuine mistakes will be viewed by the FRC. We believe most mistakes are not wilful, reckless or aimed at securing an advantage. They are simply human error which is sometimes inevitable in complex activity. It is difficult to judge from the criteria set out whether the FRC would be likely to give credit for the lack of design and intent in the mistake or simply say it nevertheless affected people or situations and is therefore serious and worthy of severe sanction.

14. Part of the above concern emanates from the processes around the use of financial penalty and the circumstances giving rise to imposition set out in paragraph 10 of the guidelines. This sets out that fines may be imposed where a body has failed to respond to other enforcement measures, or simply where a breach has occurred or both. We are not convinced that fines should be directly imposed without exploring the other enforcement measures first, and a direct imposition for simply breaching the requirements of Schedules 10 and 11 of the Companies Act without exploring remedial options appears to us to not be conducive to meeting the aims and objectives of the sanctions regime, even as they are expressed in paragraph 5 of the guidelines.

15. The framework also applies a reasonability test which is purely at the behest of the FRC. In other words it is acting as its own judge and jury in deciding whether a required course of action is reasonable, and then whether the refusal to expedite that course of action is itself also reasonable. This self-review is subjective and the approach susceptible to challenge under article 6 of the European Convention on Human Rights (ECHR).

16. It is noted that there is a reference to the High Court for a compliance order. The arrangements set out the factors that would apply for the FRC in making such a reference, but do not set out the opportunities (if any) for the recognised body to challenge such an order. This in itself is a further problem under article 6 of the ECHR. In any case use of the High Court is itself an expensive process. It is unlikely that a High Court judge would agree to be a rubber stamp and make any order without hearing argument from both sides which would then escalate the costs. Applying Hampton principles, an independent arbitration body with ultimate reference to the High Court would seem to be a more appropriate and proportionate route to follow.

17. The guidance notes refer to timescales of 14 days and 21 days in the delivery of the sanction notices, broadly following the legislation. They do not set out how the discretion around these timescales might be exercised in practice, or on the timescales leading up to the situation where there is perceived to be a need to exercise them. Bearing in mind certain outcomes will be behind the initiation of the sanctions, there is a risk that any solution will be in the nature of a “quick fix” rather than focusing on seeking sustainable long term improvements. We believe there should be some reference in the exercise of the sanctions to allowing time proportionate to the complexity of the problem or solution for the recognised body to respond.

Q2; Do the proposed Guidelines include the factors that you would expect the Board should take into account when deciding which Enforcement Measure to impose?

18. As mentioned above the factors are more widely drawn than the aims and objectives, and therefore are a bit more rounded to address the appropriateness of the enforcement action. However there are some additional elements of concern within the individual reference points given. For example;

(a) The seriousness of the non-compliance is itself a subjective judgement

(b) The circumstances of the recognised body should include that body's obligations to other oversight organisations and the potential disruption the oversight of other areas of professional services – for example the Financial Conduct Authority, the Irish Auditing and Accounting Supervisory Authority and the Legal Services Board

(c) The potential harm to the public is not defined and could be interpreted in a number of ways unclear to the recognised body

These are all areas of uncertainty which belie a transparent and targeted process required of Hampton. For the framework to be seen to be effective and fair to both recognised body and the public at large these areas need to be expounded and made clear.

19. There is no reference in the approach to the impact of types of enforcement measures on market stability or the competitiveness requirement that the Competition Commission recommended be part of the FRC's objectives. The thrust of the recent audit reforms approved in Brussels last year were centred on these key elements so it seems strange that they do not form part of the decision process in judging which measures to apply.

Q3; What is your view of the starting point proposed (a percentage of the Recognised Body's total UK fee income) for calculating the amount of a financial penalty?

20. In our submission on the proposals in December 2011 we indicated that in our view the use of financial penalties was not productive. The recognised bodies necessarily operate on a fully funded model to preserve their independence. Any addition to expense for those bodies would have to be passed on to their members, or be met by reduced expenditure, resulting in a compromise of standards and audit quality. Costs passed on to members add cost to the consumer and possible reductions in the number of licensed firms. These two factors alone compromise the competitiveness of the industry.

21. A further issue which is relevant here is the various oversight responsibilities of the recognised bodies, and the potential damage to oversight of other areas of professional services as a consequence of a financial penalty. The use of total turnover to assess penalties when only part of it is devoted to the audit oversight function is at best inappropriate and at worst a measure that is in conflict inter alia with the provisions of the Legal Services Act 2007, the Financial Services Act 2012 and company law legislation in the Republic of Ireland.

22. In our view, if revenue is to be used as a proxy for the determination of sanctions, then this should be purely based on the revenues attributable to the regulation of audit, exclude FRC levies which the regulatory bodies collect on behalf of the FRC and also exclude income related to other activities which includes income in countries outside the UK and the FRC's jurisdiction. This ironically would then leave rather a small base on which to fine, which highlights the inappropriateness of the concept in the first place. There is the issue of the size of the regulatory bodies. Using turnover ratios would mean that the big bodies are fined large amounts and the smaller ones small amounts for basically the same offence. This creates an apparent injustice and fairness problem which could again be challenged in the courts in the UK and the ECHR.

23. The practical guidelines do not set out any maximum financial penalty. This leaves the Recognised Bodies vulnerable to unlimited fines over which they have no control and which may be an uninsurable risk. This open ended liability is a risk that would deter possible future recognised bodies and indeed possibly lead to a reduction in the number of such bodies. This is not conducive to consumer protection, competition or the integrity of the financial markets. We note that in the Legal Services Act 2007 Schedule 4 similar penalties exercised by the Legal Services Board (LSB) are capped and would suggest a similar provision should be applied in these guidelines.

24. Finally there is no indication as to the use to which the proceeds raised by the regulatory penalties might be made. There is potentially a moral hazard for the FRC to start seeing the potential fines as a source of funding for other audit quality activities or other non-audit activities. Once this chain is established then there is a risk that the objectives set out in the document are overtaken by financial imperatives.

25. In short we consider the basis and approach to financial penalties as drafted is flawed and needs to be readdressed with reference to risk to the market and audit quality, intended outcomes and public interest.

Q4; Do you consider there is anything missing from the proposed Guidelines that would improve their effectiveness?

26. We have referred above to a number of factors which appear to have been overlooked. These include;

(a) Including public interest and stabilisation of markets in the principal aims and objectives

(b) The need to exhaust all channels of communication before embarking upon a sanction process

(c) Taking into account the regulatory obligations of recognised bodies to other oversight bodies and ensuring that any sanction does not compromise the ability of the recognised body to meet those obligations

(d) A use of a third party reference to determine subjective areas such as “reasonableness” where through self -interest the FRC is unable to take an objective stance

27. We also believe there are gaps in the governance arrangements surrounding the application of the sanctions process. It is not clear what part of the FRC is determining that the regulatory body is at fault, whether the Conduct Committee is involved in that process, and to what extent the Conduct Committee has involvement in the appeals process. As things stand it seems to us that there is a considerable risk of self-review in the decision process and as a consequence the sanctioning process could be regarded as unfair and open to challenge by the regulatory bodies through the courts. This places the integrity of the FRC and the regulatory regime as a whole at risk and results in costs to the firms and ultimately the companies which are supposed to be benefiting from the oversight arrangements.

28. In this connection we would draw attention to parallel arrangements for sanctions in the Legal Services Act 2007. Under section 37 of that act the LSB can only apply fines in certain specified situations. In addition as noted above the fines need to be capped and this, and the rules the LSB put in place for fining, have to be agreed by the Lord Chancellor. This oversight of the overseer at ministerial level is an important safeguard in the regulatory sanctions process. In contrast under SI 1741 2012 article 7 all powers of the secretary of state relating to section 1225 CA06 (covering this regime) were fully delegated to the FRC without the safeguards retained in Legal Services Act 2007. This is a weakness in the framework contributing to the self-review problems

29. We have separately above expressed concerns around some of the subjective definitions being applied in the decision process and suggested a third body be involved in that process. We have also expressed concern about the management of income from the fines which perhaps needs to be monitored by an independent trustee body to ensure non-dependency on this income. Altogether we would therefore recommend that governance and independence should form an integral part of the sanctions document.

30. The document does not address what happens to costs in the event that an appeal by the regulatory body is successful. Would these costs simply be left with the regulatory body, or would they become costs to the FRC which would then recharge them through all the recognised bodies as a levy and ultimately to the firms and their audit clients? The financial under-pinning of the process needs to be clarified.

31. The grounds for appeal are currently listed out in paragraph 1.17 of Appendix 1 of the document. These grounds do not appear to include reasonableness with regard to the finding or of the original requirement. Reasonableness as a test is only applied to the timing and amount of penalties. The insulation from any challenge is not considered an appropriate regulatory mechanism for any oversight body whose functions must be transparent and fair. We would suggest that reasonableness of finding should be included in the bases for appeal.

Q5; Do you have any other comments about the proposed Enforcement Measures?

32. We have set out in the introduction and the above questions the principal matters that we wish to draw to your attention in this representation.